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FYI -- for the "Mexico lunch" participants:

[redacted]

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After the Peso's Devaluation, Mexico Fails to Qualify

LAST TIME we looked in on the Harvard Graduate School of Business Administration (Aug. 31, 1981), one of its leading lights had just prepared a fascinating case study for the class. It involved the case of James Chilton, who handles the finances of the $400-million Rayburn Foundation (all names are fictitious, presumably to protect the innocent). 'One weekend in June, Chilton grappled with a major investment decision: whether to sink several million dollars into a newly formed closed-end investment company called the Mexico Fund. Among the variables that he had to juggle: shares of the Mexico Fund might sell at a discount from net asset value, leading to an immediate paper loss; the secondary market in the Mexico Fund was likely to be thin, making it difficult for a large institution to accumulate a sizable position. "Finally, Chilton remembered the early days of the Japan Fund, when it traded not at a discount, but at a premium, and he wondered if this might not happen here, too." Unlike Chilton, the B-school professor had no trouble making up his mind. The underlying shares of the fund, he noted, were selling at around four-to-five times earnings (fully adjusted, by the way, for inflation). Last time around, moreover, devaluation triggered a four-fold advance in the Mexican Bolsa. "Buy," suggested the scholar.

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The rest, as the saying goes, is history—not to mention current events. After an auspicious debut, which generated a demand so hot as to persuade the underwriters to increase substantially the number of shares for sale, Mexico Fund swiftly headed south. From an offering price of $12 per share last June, it moved to a small and short-lived premium; by late July, when the Chilton case study surfaced in a differet setting, the stock was changing hands below 10. Last week, it traded quietly around 4¼.

Meanwhile, back at Harvard Business School, the powers-that-B were clearly having second thoughts on a number of issues. Two weeks ago, in a precedent-shattering move that made headlines, the faculty sharply reduced the students' work load. "The primary problem," explained an associate dean, in an apologia that would have rung a bell on Wall Street, "is that we have been trying to deal with too many topics in too little time and not in enough depth." Added a professor: "We hope there will be an increase in thinking time."

A worthy goal—and not just in and around Harvard Yard. For as the dismal performance of the Mexico Fund indicates, the gringos aren't the only ones who failed to do their homework. At the time of our last survey, Mexican government spending in half a decade had nearly quadrupled, while the federal deficit was heading for $13 billion, equivalent in U.S. terms to five times as much. Borrowing abroad was surging by leaps and bounds, and inflation was running at an annual rate of 30% per year. Optimists were looking for a 15%-20% decline in the value of the peso; pessimists (among whom we were numbered) predicted something worse. Two months ago, despite repeated official denials, the peso was devalued by 28%, or from roughly 27 to the dollar to 38. Last week, at barely two cents apiece, the peso had dropped by 40% and no end to debasement seemed in sight. According to one official, described (in London's *Financial Times*) as a "senior government economist", the currency will be allowed to sink to little more than a cent and a half by year-end.

South of the border, such numbers indicate, things are going from bad to worse. And so they are. Since devaluation, the Mexican government (which, under the one-party system that has controlled the country ever since the Revolution, more than half a century ago, is getting ready to inaugurate a new President on July 1) has pursued inflationary, destabilizing policies. To cushion the impact of devaluation on the workers, for example, it has decreed huge boosts in wages while clamping ceilings on prices. Despite halfhearted gestures toward economy, its profligate spending has persisted, to the point where capital markets abroad are casting a colder and colder eye on Mexican credit demands. Inflation has doubled, to a near-runaway rate of 60% or more, and unrest is growing. The country has always lived, so to speak, on a volcano. Now, hell-bent for election, it seems to be rushing down the slippery slope.

Nor is the plunge of the peso purely a local concern. From Day One, its adverse effects were felt in all the border towns, which once did a thriving business selling American products to their southerly neighbors who now find themselves priced out of the market. By the same token, owing to currency translations, U.S. companies which operate in Mexico—Becton Dickinson, Bic Pen, B. F. Goodrich, Kimberly-Clark and Mohasco come to mind—all will suffer financial loss. Far and away the worst reverses shape up for those who, despite compelling evidence to the contrary, cling to the notion that Mexico is either an authoritative guide to Third World sentiment or a reliable collaborator in foreign affairs. Starting with the abortive summit meeting in Cancun last fall, where the U.S. took a surprisingly hard-nosed stance, State Deprtment officials, in an effort to deal with such simmering crises as Nicaragua and El Salvador, repeatedly have tended to view Mexico as a kind of honest broker. To judge by the way it has handled its domestic problems, it qualifies on neither count.

Which is not to put the Mexico Fund in the same category as Czarist bonds, or to deny that the country boasts enormous natural advantages, including some of the richest oil deposits in the world. Thanks to such resources, the national economy, until lately at any rate, was enjoying steady gains of 7%-8% per year in real growth. Coupled with the accession to power of a less doctrinaire, more pragmatic President, the previous devaluation, back in 1976, triggered a powerful advance in the local stock market; in a few years' time, the Bolsa surged four-fold. Yet in mid-'81, as the bullish professor cited above was quick to point out, the shares owned by the Fund were selling at only four-to-five times earnings. Though overextended and underrepresented in "thinking time," as events quite plainly have shown, there is still something to be said, after all, for a Harvard education.

Even as Wall Street was buying the concept, skeptics—cited time and again in these pages—abounded, both at home and abroad. Nine or so months ago, a sustained flight of capital set in. Importers and exporters began to play their customary games of leads and lags. Money funneled into real estate north of the border, to the point where newspapers in Mexico City were flooded with offerings in California, Colorado and Texas, while some enterprising realtors hired Spanish-speaking salespeople. By late February, the central bank had virtually exhausted its holdings of foreign exchange, and, despite repeated pledges to the contrary by the Minister of Finance (who recently resigned), devaluation loomed as the only way out.

Last time around, devaluation worked: the Bolsa took off, and flight capital poured back into the country. This time things are ominously different. After a one-day rally, stocks have sagged back to their previous lows, while funds held abroad have signally failed to return. In view of the alarming policies that the government lately has chosen to pursue, that's not surprising. Take wages. On top of a 34% increase in the minimum wage imposed in January, the authorities, to the dismay of the business and financial communities, recently decreed a further 15%-30% rise. They simultaneously slapped a lid on the prices of over 5,000 products, a draconian measure that they swiftly moved to enforce by shuttering the premises of offenders, including several major U.S. and U.K. retailers. On the foreign exchange markets, as noted, the peso remains persistently weak.

Small wonder that bankruptcy looms for a great many enterprises, or that the rate of inflation currently seems to be nearing 75%. And Mexico's credit abroad is steadily eroding: from slightly over LIBOR (the London interbank rate) a year or so ago, federal entities like Nafinsa and Pemex are paying closer to a 1% premium. Meanwhile, some leading London market-makers have stopped bidding for Mexican floating rate notes. "I feel like a python that has swallowed a monkey," one American banker not long ago was quoted as commenting about the over-supply of Mexican debt. "At the moment it's a huge lump."

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U.S. companies also are feeling far from well. Since the peso was devalued, half-a-dozen, including those cited above, have disclosed potential losses running into millions of dollars on their Mexican holdings, and, if the economist quoted above is correct, the end of the drain is not in sight. Yet Washington, in wrestling with its foreign policy decisions in the Western hemisphere, persists in making this inflation-ridden, ill-governed and ideologically suspect regime its spokesman. Big mistake. A country that so badly mishandles its affairs can scarcely command respect—except, perhaps, at institutions of higher learning—abroad.

—*Robert M. Bleiberg*

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Mexico's Miffed Middle Class May Form A Potent Political Force, Observers Say

By LAWRENCE ROUT

Staff Reporter of THE WALL STREET JOURNAL

MEXICO CITY—It's a familiar scene to anyone who passes the U.S. embassy here during the day. The lines spill into the street, as hundreds of Mexicans wait hours for a temporary visa to visit the United States.

To some, the throngs of businessmen and tourists are a joyous symbol of Mexico's oil wealth and of the four-year economic boom that only now is ending. But to many others, the lines are an omen of what may be the government's biggest future challenge: a growing middle class.

It isn't a concern that fills today's newspapers or dominates policy decisions. The country's economic crisis has pushed most everything else into the background. But an increasing number of people are thinking, and worrying, about the middle class.

Foreign Insight

"The middle class runs the risk of losing its sense of social solidarity," which could upset the political system, Miguel de la Madrid, the almost-certain winner of this July's presidential election, told a recent gathering outside Mexico City.

Rafael Segovia, a political scientist at the Colegio de Mexico, is more blunt. "The dissatisfaction of the middle class is the most dangerous threat to the ruling party," he says.

The problem has its roots in Mexico's one-party system. Opposition exists, but the ruling Institutional Revolutionary Party, or PRI, has won every presidential election since 1929.

Coalition of Unions, Peasants

The party's winning streak is built on a coalition of peasants and labor unions, controlled in part by co-optation: It is common to hear that a former student leader, who five years ago preached revolution, is now a ranking PRI member.

The middle class, however, has never given the PRI such fervent support. It occasionally votes for an opposition candidate. But mostly, it hasn't voted at all. Many professionals in Mexico City claim not to know anybody who has ever voted for the PRI, even though it received 75% of the vote in the most recent election for the Federal Chamber of Deputies.

At first, middle-class apathy made little difference; the middle class just wasn't big enough to matter. And later, the ruling PRI simply nurtured the apathy. "The state has made the middle class the most subsidized class in Mexico," says Mr. Segovia, the political scientist. "It has given them cheap education, gas and water. And in return, the middle class gives its passive support."

But all that may be changing, and if so, some people believe it could alter the balance that has kept the PRI solidly in power for 52 years.

For one thing, the middle class has grown substantially. Nobody has hard figures, and income distribution is still badly skewed to the extremes, but economists say that the economic boom since 1978 has swollen the ranks of the middle class. As proof, they point to the rise in consumer spending and travel to the U.S., and to the construction of big shopping centers.

But the growth also has brought discontent. The consumer price index, for instance, rose 29% last year. "But that is an index for the poor," says Ofelia Alfaro, an economist at the National University of Mexico. "For the things the middle class buys, inflation was at least 45%."

Some observers say that worsening corruption preys mostly on the middle class, because they use the services that require bribes. If we want to send our children to a private school, people say, we must pay somebody. If we want to get a driver's license, money must change hands under the table.

Meanwhile, the government has begun to withdraw some subsidies. In December, it doubled the domestic price of gasoline. And most people figure that the current economic crisis will force government to raise taxes and cut capital projects in the cities in the next few years—only heightening the discontent of the middle class.

"The system can no longer afford to coopt the middle class because there are too many of them and, having had a taste of U.S. life, their demands are growing too fast," says Francisco Jose Paoli, a political scientist at the Metropolitan Autonomous University at Azcapotzalco. "It is true they have more than most in Mexico. But they are aware of the possibilities, and they want more."

Nobody yet knows how the middle class will channel such discontent, if at all. The opposition parties, however, already are showing interest, and many people are predicting that the PRI won't get a majority of the votes in Mexico City this July.

"The middle class isn't politicized yet," says Luis Sanchez Aguilar, president of the one-year-old Social Democratic Party. "But we are seeking a formula, and if economic problems persist, we are convinced they will look for someplace to put their votes."

A Splintered Class?

It will be a difficult formula to find. The middle class is a heterogeneous group, with divergent aspirations. Many of them hope to win secure and well-paying government jobs. And they are very unlikely to move *en masse* to any one party.

The government apparently wants to keep it that way. A 1977 law permits more opposition parties than even before; Mr. de la Madrid will face at least six challengers in July, and many of them are trying to win support from the middle class.

Any party also has to overcome the fear, common throughout all classes in Mexico, of voting for somebody other than the PRI candidate. It isn't a fear based on PRI retribution, but rather the fear of losing the peace and stability that has marked the PRI reign. Very few people think another party can govern this country.

Still, the middle class has other options, and there are signs that it is starting to use them. Mr. Segovia notes that middle class citizens have begun to sue the government over changes in tax law—an approach unheard of a few years ago. Moreover, an anticorruption campaign has been mounted in the press, which rarely wrote about corruption in the past. And small independent labor unions, not tied to the PRI, are growing.

"It's true that the middle class isn't likely to organize in a political sense in the next couple of years," Mr. Segovia says. "But in the meantime, it still is very capable of political disruption."